

**MERGERS AND ACQUISITIONS:  
AN ANALYSIS OF STRATEGIES FOR CORPORATIONS  
DESIRING TO HOLD UNDERVALUED REAL ESTATE WITHOUT  
THREAT OF HOSTILE TAKEOVER**

by

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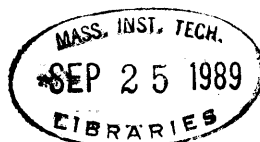
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## **ABSTRACT**

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## **PREFACE:**

Since the 1960's, corporate mergers and acquisitions have been commonplace in the free markets. Only recently, however, have transactions been targeted toward specific assets, thereby replacing former strategies toward expansion of product lines and/or diversification.

The purpose of this paper is to provide an introduction to mergers and acquisitions in today's environment, specifically applied toward publicly traded companies including examination of the reasons for the current trends (Chapter 1). Second, the paper analyzes various planning considerations including actual strategies implemented by companies with respect to their undervalued assets when faced with a hostile takeover attempt (Chapter 2). In addition, the perspectives of the acquiror, the investment and commercial bankers, and the acquired entity are given (Chapter 3). Case studies involving Perini Corporation, MacMillan Inc., and U.S. Home Corporation are presented (Appendices 1-3). Finally, suggestions are made to those publicly traded companies wanting to use their real estate as an integral part of a plan to avoid hostile takeover (in Chapter 4).

## **RESEARCH AND METHODOLOGY**

The main thrust of this study is directed toward the senior decision makers who, have only recently, begun to view real estate as an asset that must be effectively managed. The focus is on the need for effective management of a corporation's real estate assets which is an integral part of management's responsibility. **Therefore, it follows that real estate must play a role in any decisions concerning the strategies invoked for prevention of hostile takeover.**

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## **BIOGRAPHICAL NOTE**

Robert C. Reeves, Jr., a native Texan, is a candidate for a Master of Science in Real Estate Development at Massachusetts Institute of Technology. Mr. Reeves is 29 years old and also holds a Master of Business Administration and a Bachelor of Business Administration in Accounting from the Hankamer School of Business at Baylor University.

Mr. Reeves is a Certified Public Accountant in the state of Texas and was formerly employed by both Arthur Andersen & Co. and Ernst & Young, each for three years. While at Arthur Andersen & Co., he specialized in the field of international taxation focusing on the structuring of corporate entities owning U.S. real estate. While with Ernst & Young, Mr. Reeves, as a tax manager, focused on corporate and financial planning including mergers and acquisitions and the banking and savings and loan industry.

He also holds several years of real estate experience in residential land and single family home development in the Houston area as well as the renovation of a condominium project.

## ACKNOWLEDGEMENTS

The writing of this text involved a great deal of personal interviewing since little has been published on the topic. Particularly, I would like to thank Mr. Tom Steele of Perini Investment Properties and Ms. Kelly Somoza of U.S. Home Corporation who were instrumental in providing me information on their companies allowing me to exemplify actual strategies involved by corporations concerned with the threat of hostile takeover. Also, I would like to thank Dr. Marc Louargand for his assistance in maximizing the potential of this writing.

In addition, I would like to acknowledge my former employer, Ernst & Young, Ernst & Young's National Real Estate Advisory Group, and Ms. Linda McCay and Mr. Michael Evans for the firm's role in the underwriting of this publication and general interest in the topic. I would like to thank Mr. Charles Foto, formerly of Ernst & Young who contacted the National Real Estate Advisory Group, on my behalf, and assisted in obtaining their support for this writing.

I would like to thank my classmates of the **1989 Graduating Class of the Center for Real Estate Development** for a very interesting year that has broadened my perspective in countless ways. Particularly, I wish to acknowledge Ms. Tina Brooks, Ms. Kitty Cox, Ms. Jane Harris, and Mr. Joe Hill. Good Luck to all!!

Above all, I would like to thank my parents, Mr. and Mrs. Robert C. Reeves, Sr. of Houston, Texas for their never-ending emotional support without which I would not have finished this degree. Most of us are not provided the luxury of having parents that are also good friends. I am happy to say that I am one of the few.

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## CHAPTER 1

### THE MERGER AND ACQUISITION PERSPECTIVE

**"The motivation for takeovers is simple: the chance to make money. If a company is underperforming, that is {it is} not doing as well as it could with the assets at its disposal, it represents a chance for an acquiror to reap the rewards of management's inattention." (1)**

-----Ennius E. Bergsma

Since 1984, mergers, acquisitions, and leveraged buyout (LBO)s totalled a staggering \$880,268,500,000. Calendar year 1988 alone accounted for \$223 billion. Of this 1988 amount, 70.3% represented U.S. entities acquiring other U.S. entities. The questions arise: what factors have led to this flurry of activity? (2) Also, what role does real estate, if any, play in these acquisitions? Is it possible to effectively utilize real estate assets as a defense strategy against hostile takeover?

**This study examines strategies invoked by companies that create, acquire, or own substantially undervalued real estate. Specifically, the study makes recommendations for the application of these strategies to assist publicly held companies hoping to prevent an unwanted takeover.**

### **HISTORICAL PERSPECTIVE**

Traditionally, mergers and acquisitions have occurred to increase efficiencies within the corporation. In theory, efficiencies result in the most economical allocation of resources at a company's disposal to achieve corporate goals with a *primary objective: maximizing shareholder wealth*. According to David J. Ravenscraft & F.M. Scherer authors of Mergers, Sell-Offs, & Economic Efficiency, firms may acquire for three reasons:

a disparity of valuation judgements, given uncertainty about future business conditions, ... the buyer believes it can run the acquired entity more profitably as a part of its organization than the seller could by remaining independent, ... those who control the acquiring entity seek the prestige and monetary rewards associated with managing a large corporate empire. ... **A common contention concerning unilateral takeover attempts is that management of the target company has been derelict in its duty to**

**maximize profits and that, by reorganizing and reorienting operations, the acquiring entity will improve matters. (3)**

Ravenscraft and Scherer note "four great merger waves...have marked American industrial history" - one peaking in 1901, a milder one occurring during the late 1920s, a third peaking in 1968, and a resurgence as displayed currently (in the 1980s). Ravenscraft and Scherer note that the merger wave of 1901 "was preponderantly horizontal, uniting large numbers of competitors into consolidations that often dominated the markets they served." The authors note that the 1920s wave focused on the public utility sector, while the 1960s activity was primarily "conglomerate in character." "The mergers of the 1980s were different {than previous waves}. Antitrust enforcement ebbed, permitting more and larger horizontal mergers. In addition, financial intermediaries had become more free-wheeling in the kinds of mergers they would support, and as one consequence, hostile takeovers rose to unprecedented prominence." (4)

Their research indicates that:

...a sizable fraction of the acquisitions made during the 1960s and early 1970s were subsequently resold. Our best estimate within a wide range of uncertainty is one-third. Acquired units were much more likely to be subjected to divestiture, and especially full divestiture, than lines already operated by the parent companies in 1950. Poor and declining profitability, at the line of business or company level or both, characteristically preceded sell-off. ... For both acquired and original lines, sell-off was on average a manifestation of financial distress. This does not mean that the sell-off per se was in some sense bad; rather, bad conditions precipitated the decision to sell. Our case studies reveal that substantial efficiency increases often occurred under the new organizational structures established following divestiture. (5)

The President's Council of Economic Advisers, in a report to Ronald Reagan, in February of 1985, stated:

Although extensive research has established that takeovers tend to be beneficial, not every takeover is successful in attaining its originally contemplated benefits, and there are many examples of takeovers that, in hindsight, appear to have been misguided. Takeovers should not, however, be singled out in this regard because investments in physical plant, research and development, petroleum exploration, and numerous other activities also often appear misguided in hindsight. However, because it is impossible to predict which takeovers will be unsuccessful, the takeover process must be evaluated in the aggregate, and cannot be assessed on the basis of isolated examples of failure or success.



Ravenscraft & Scherer agree with that statement. They, however, carry it one step further noting that the Council did not recognize that the merger wave of the 1960s - the last great merger wave before the one that captured the council's attention in 1985 - led to efficiency losses substantially exceeding identifiable gains. They seek to dispel the attitude held by "thousands of would-be managers and middle managers pour{ing} from the business administration schools each year imbued with naive views of merger-making as a quick, easy road to wealth creation." (6)

**Given the mediocre results of the 1960s and 1970s mergers and acquisitions, mergers and acquisitions should be performed by those utilizing the best sources of information and having extensive knowledge of their own corporations and lines of businesses. Only then, is management likely to affect a successful business endeavour.**

### **WHAT FACTORS HAVE LED TO THE MERGER AND ACQUISITION ACTIVITY OF THE 1980S?**

In the 1980s, acquisitions have also occurred for reasons other than economies of scale: to increase strategic positioning, the globalization of the world's economy, and the call for effective management of a corporation's entire asset base, all having direct effects on a corporation's earnings.

### **CORPORATE GROWTH**

Since many mergers appear to be unsuccessful, why would a company want to merge with or acquire another line of business? To assist us in answering this question, an understanding of the theory on corporate growth is essential. In a recent Mergers & Acquisitions article, Joseph E. McCann and William G. Cornelius stated that corporate growth can be explained in terms of a lifecycle which involves four separate stages: start-up, take-off, strategic positioning, and sustained performance or decline. During the **start-up stage**, the firm is most concerned with "establishing a viable market presence, often with scarce resources." The **take-off stage** focuses on establishing a market presence with the key challenge of continued growth without a decline in product service and quality.

For our purposes, the **strategic positioning stage** is most relevant to our analysis.

The strategic positioning stage is entered as the rapidly growing firm begins to consolidate its initial growth and rationalize its structure and operations. It is time to take a deep breath, look around, and figure out how to best position the firm for long-term sustained growth. The rate of growth may begin to slow in this stage, but profitability should begin to improve as gains from early market entry can be reaped. ... It is at this stage, however, that acquisitions begin not only to make more sense, but become more feasible. Financial capacity has improved. Management is more experienced and knows the industry's competitive structure better. Executives also may have more time to devote to searching, negotiating, and integrating acquisitions. **Acquisitiveness becomes an opportunistically driven exercise designed to position the firm for sustained growth.**

The final stage of corporate growth is characterized by **long term performance and/or a general decline**. During this stage, high rates of growth have peaked, and the firm "either has plateaued or been caught in competitive pressures that may temper growth rates." In summary, mergers and acquisitions occur for different reasons dependent on the particular stage of corporate growth the corporation is in. (7)

### GLOBALIZATION OF THE WORLD'S ECONOMY

Merger and acquisition activity has definitely not been limited to the U.S. as confirmed by recent trends toward globalization of the world's economy. "The past five years have brought an astonishing increase in unsolicited takeovers in both the US and the UK. The surge in activity, which began in the US and has now spread to Europe, is due to the confluence of three factors; means, opportunity and motivation." (8) 17.3% of all acquisition activity in 1988 was international in origin, with 12.8% attributable to non-U.S. companies acquiring U.S. corporations and 4.5% attributable to U.S. corporations acquiring foreign entities.(9)

### MEANS

Limitations on size of mergers and acquisitions because of financing constraints is no longer a problem as exemplified by the 1988 \$25 billion LBO acquisition of RJR Nabisco Inc. by Kohlberg Kravis Roberts & Co. which rocked the financial markets due to its sheer size. The merger and acquisition market has matured to the point where it can handle bigger and bigger deals." (10) "{Generally}, the US capital markets are awash with liquidity." (11)

**Wall Street's creative minds can make debt financings almost infinitely flexible.** Companies used to keep large reserves of cash idle in the bank; now the vogue is to pay bankers a modest fee to keep a line of credit open. With prearranged shelf-registration, it is possible to float 30-year bonds in a matter of hours. In this environment, savvy chief financial officers can tailor borrowing terms to support corporate strategy. (12)

## OPPORTUNITY

The trend in international acquisitions is only just beginning. As the formation of a single European market in 1992 approaches, mergers and acquisitions should continue on a massive scale.

**The essence of opportunity for potential acquirors is the existence of underperforming companies, and every country and every industry has them.** ... For companies and investors looking for promising deals, the path toward 1992 {the date of the emergence of the European Economic Community} is strewn with opportunity. Moreover, as the public comes to recognize the value of increasing pan-European activity, takeover attempts will become more acceptable, more legitimate, and, not least, more common. ... The coming reforms in Europe, which will make it possible for companies to enter new markets and obtain economies of scale that were hitherto unrealizable, adds to the appeal of takeovers.(13)

## MOTIVATION

The sale of real estate can have a tremendous impact on corporate earnings. According to a recent survey of the nation's 500 largest corporations, these companies hold approximately \$2 trillion in real estate or one-third of their total book value.(14) **"By selling off some assets and better deploying others, an acquiror can increase the value of a company, and, with it, the acquiror's wealth.** The stakes can be enormous. ... Studies have found that the increases in value that can be generated this way are often in excess of 50% of the original market value of underperforming enterprises." (15)

Examples include **Citicorp** which sold one-third of its headquarters in the summer of 1987 to a Japanese insurance company to help offset possible loan losses from Latin American loans. **"Time, Inc.** recently sold its 45% interest in its Manhattan headquarters to the building's co-owner, **Rockefeller Group.** ...". In what was deemed as "... a 'strategic sale', Time received cash and was able to bargain successfully for an improved long-term lease that will keep it on Avenue of the Americas for the foreseeable future."

One of the prime examples of relying on real estate assets to bolster a company's fortunes occurred last summer, when **Allegis Corp.** began to dismantle the travel conglomerate put together by former chief executive Richard Ferris. ... With **First Boston's** help, Allegis auctioned off its **Hilton International** hotel chain for an impressive \$1.07 billion. Hotels are hot today because of their management contracts and underlying real estate - not because of any boom in tourism. The purchaser, **Ladbroke Group** of Great Britain, represented by **Merrill Lynch**, ended up with 88 hotels in 42 countries.

Allegis then retained First Boston to dispose of its **Westin Hotel** group. With New York's Plaza Hotel and the Mauna Kea of Hawaii included in the Westin portfolio, First Boston managed to sell the package of 60 hotels management contracts and ownership interests in 27 hotels for a staggering \$1.53 billion. The winners: The **Robert M. Bass Group** and Japanese hotelier **Aoki International**, which were brought together by **Sonnenblick - Goldman**. The Bass - Aoki team has since resold the Plaza and the Mauna Kea for approximately \$700 million. (The former property was purchased for \$400 million-plus, by New York developer **Donald Trump**.) ...

... And the banks are not above heeding their own advice. Last fall Merrill Lynch sold its option to purchase one of its new Manhattan buildings back to **Olympia & York Developments**, and several months later First Boston sold its interest in its Park Avenue headquarters for an estimated cash profit in excess of \$100 million, providing a handsome offset to recent trading losses. (16)

### EFFECTIVE MANAGEMENT OF CORPORATE ASSETS

Management is responsible for providing the stockholder the highest return on his/her investment through production of current net income (dividends) and also the long term creation of value (stock appreciation/capital gains). With respect to this role, "two developments since the 1960s have required special treatment of real estate assets: the increasing complexity of corporate organizations and the inflation of real estate values." (17)

The market for corporate control is here to stay. Managers face a new challenge: establishing and maintaining an advantage in this market, as well as in the more traditional markets for goods and services in which they are accustomed to competing. ...

And there is only one way for managers to maintain a competitive advantage in the market for corporate control: creating more value with the assets entrusted to them than any other management team could. Managing value has become the central mission for managers, the one without which there are no others.

To manage effectively, three conditions need to be met: {the CFO must} have ... the right measures for performance, make sound reinvestment decisions, and determine whether you {the corporation} continue to be the right owner of your businesses. A company's chief financial officer should play a role in the attainment of each of these objectives.

... In today's environment, managing value is not merely prudent, it is indispensable. The CFO must be at the center of this effort: first, with responsibility for **establishing the right standards for tracking performance** - standards that are directly related to market value - and **communicating them to external constituencies as well as management**; secondly, **scrutinizing reinvestment decisions** to make certain that they create, rather than destroy, value; and thirdly, **ensuring that the company continues to be the best owner of its businesses**.

**The fact that a business has been part of a corporate portfolio for a long time does not necessarily mean that the corporation is still the right owner.** When another owner can extract better cash flows at lower financing cost, it is in the interest of shareholders that such potential value get realized. (18)

Unfortunately, the effective management of real estate assets has not improved since 1981. According to a 1987 study by the Massachusetts Institute of Technology entitled "Managing Corporate Real Estate Assets: A Survey of U.S. Real Estate Executives", **"despite tremendous value, corporate real estate assets are often under-managed."** The survey respondents included the Fortune industrial 500, the Fortune service 500, 197 public agencies, 34 academic organizations, 4 nonprofit institutions, and 663 members not listed in the other groups was based on similar research conducted in 1981 by Harvard Real Estate, Inc. (HRE) (19) Among its findings:

Corporate real estate, as indicated by the HRE survey, represented a vast proportion of corporate assets which, by and large, was undermanaged. That{HRE} study highlighted the reluctance of companies to manage their buildings and land as separate and independent assets; the absence of adequate data and information on these assets; and the lack of diagnostic tools for guiding and evaluating real estate performance. The{MIT} study concludes that the decision to manage corporate real estate effectively and efficiently appears to have more to do with the attitudes of top management than with the nature, size, value, or function of the properties themselves. **Today, in 1988, the state of corporate real estate remains much the same.** {as it did in 1981.} ... (20)

"The market value of a corporation's buildings and land typically represents 25 percent of total assets but ranges from 10 to 50 percent and in some cases is reported higher. Among those surveyed, less than half consistently evaluate their real estate separately and independently from other corporate assets - either as a cost center or profit center. Many corporations do not evaluate their real estate at all." (21)

Unfortunately, the study also revealed the following:

- \* Large numbers of corporate real estate managers do not maintain adequate information on their real estate assets.
- \* One in four does not maintain a real estate inventory.
- \* Two out of three do not maintain a real estate management information system (MIS).
- \* One in four is uncertain of the market value of the organization's real estate.
- \* One in three is uncertain of the acquisition cost. (22)
- \* 60% of the firms did not calculate real estate returns for comparison with the overall corporate rate of return.
- \* 29% of the respondents report analyzing and preparing information for top management review on any scheduled basis.
- \* Approximately two-thirds "... felt that real estate played a 'critical role' in the overall performance of their organization." (23)

Given the results of these studies, it is evident that management is not effectively utilizing its real estate assets. Clearly, to fulfil its role, corporate management must begin to effectively manage its real estate by including real estate in its strategic decision making.

**In summary, merger and acquisition activity in the 1980s has been caused by the traditional goal of economies of scale. Equally important are strategic positioning for corporate growth, the globalization of the world's economy, and a call for more effective corporate management.**

### **DOES REAL ESTATE PLAY AN IMPORTANT ROLE IN MERGERS AND ACQUISITIONS?**

According to William Myers, author of "Corporate Real Estate Comes Out of Hiding,"

the appetite for corporate real estate among other companies and raiders is substantial. And among developers as well: **Robert Campeau, Edward DeBartolo, Donald Trump, A. Alfred Taubman, Melvin Simon and the Reichmann family** all figured in the big **Federated Department Stores** shoot-out... Soft markets or no, property values in most parts of the country have tended to keep rising, albeit more modestly than before. Rents are generally expected to remain strong, making companies with cheap, long-term

leases particularly attractive to acquirors. And raiders and LBO groups are able to finance their takeovers by using the acquired firm's real estate as partial collateral - debt far cheaper than junk bonds.

A confirmation of the new importance of real estate assets is reflected in the attention now paid to them by top management. In the past, {very recent and still actually the case in most cases according to the MIT study}, a low-level facilities manager was assigned to look after a company's offices, factories, warehouses and land. This is now the job of the chief financial officer. ...

CFOs are learning how to borrow against brick and mortar rather than relying on corporate credit. The pledged assets lower the cost of money considerably. ... Or property can simply be sold, to streamline the balance sheet or help solve pressing corporate problems. ...

**The blending of corporate finance and property has inevitably involved investment banks, which have helped clients assess real estate assets as a financing alternative, part of a restructuring or as a takeover attack or defense strategy. ... Today almost every M&A team on the Street goes into battle with a group of real estate specialists at its side. ...**

Seeing so much tempting real estate coming into play and the development business in a slowdown, many real estate developers have stopped constructing shopping malls and office towers and started raiding. ... It's a lot easier to buy a company than to put up a 50-story office tower yourself, sums up one New York builder. (24)

"The fact that many companies undervalue their real-estate holdings has long been known" since assets must be reflected at historical cost for financial statement purposes in accordance with generally accepted accounting principles. What makes these holdings so much more valuable currently is that while stock values {may plummet}, the real estate market has {generally} remained firm." (25) Again, these factors point out that management must effectively manage corporate real estate to maximize value to the shareholder.

**Therefore, real estate plays an important role in many mergers and acquisitions. From the acquiror's viewpoint, real estate is an untapped asset that is not reflected on the balance sheet of the target. From the target's viewpoint, it is an asset which can be borrowed against in a financing strategy, and from the investment banking perspective, all transactions will generate consulting and/or financing fees.**

## STOCK MARKET CONSIDERATIONS

In their book, Ravenscraft & Scherer also discussed the theory of "stock market event studies" in view of the announcement of a merger.

Using methods derived from the capital asset pricing model, each company's stock prices are normalized to take into account the price movements of all traded stocks bearing comparable risk. Cumulative deviations from the normal pattern are computed for the acquired and acquiring enterprises. ... **For the firm acquired, stock prices trend downward relative to the norm from six months to two years before the merger announcement "event", so that cumulative abnormal returns are negative. Shortly before the merger announcement, the acquired firm's stock prices begin drifting upward, presumably because of leaked information about the impending event, but perhaps also because investors recognize that the firm is a prime candidate for acquisition. Usually, the acquiring company offers a sizable premium above the target firm's previous stock price to persuade the latter's management to accept the merger proposal and/or to induce shareholders to tender their shares. When the merger and its accompanying premium are announced, the target's stock prices rise sharply ... If the merger occurs, of course, the acquired company's stock disappears; if the merger falls through, there is a tendency for the target's stock prices to drift downward again.**

**What happens to the acquiring corporation's stock during this period is less uniform and certain.** Most commonly, ... the acquiror's stock prices drift upward relative to the norm during the year or two prior to the merger, that is, positive abnormal returns are achieved. The weight of evidence suggests that acquiring firms realize no abnormal returns, positive or negative, between the month before the merger announcement and the month after consummation, after which a weak downward trend may materialize. ...

These stock price movement patterns are interpreted as having important "real sector" behavioral counterparts. The combination of positive returns to acquired company shareholders and (at least in the short run) zero or mildly positive returns to acquiring firm shareholders is viewed as evidence that mergers are on average value-enhancing.

To the extent that acquiring companies realize no abnormal returns on average from the merger activity, it must be asked why they share so little in the resulting benefits. One possible answer is that to be the successful acquiror, one must bid up the target firm's stock price until the winner's cure, - that is, the tendency for only the most eager competing bidder to win - has left the acquiror only a minor share of the added expected value.

One difficulty with the view that the stock market value increases reflect efficiency increases is that an alternative set of hypotheses can also explain the stock price patterns associated with merger events. It says that at any moment in time some companies are undervalued by the stock market, while others are



overvalued. Companies with undervalued stock - that is, inappropriately negative cumulative abnormal returns - are "bargains" and hence become prime targets for acquisition, ... by companies possessing the uniquely economical currency of overvalued stock. In other words, the depression of acquired firms' cumulative abnormal returns before the merger event is the result of mistakes by the stock market, not mistakes by the managers who have failed to maximize profits. The premium paid then reflects not the expectation of enhanced future operating efficiency, but the difference between the bargain price at which the target firm's stock is selling before merger and the price that would have to be paid in a competitive market recognizing the target's true value. ... (27)

The stock market "events" theory was recently applied to real estate in a research conducted by Professors Davidson, Glascock, and Sirmans at Louisiana State University in November of 1988 entitled "The Separation of Real Estate Assets and Divisions Through Selloffs."

... We examine{d} 93 selloffs involving real estate assets of divisions and find that the selloff is associated with positive abnormal returns for the sellers. This abnormal returns occur immediately before the Wall Street Journal announcement. **Buyers, however, do not earn abnormal returns. This outcome is consistent with the general evidence for acquisitions and selloffs.** Our results suggest that in general the acquisition or selling of realty corporate assets is similar to other corporate assets. However, there may be managerial ... and tax ... reasons ... that provide buyers an opportunity to earn economic profits. ... **Overall, the market reaction to an announcement of an asset or division selloff is consistent with other corporate asset selloffs.** In particular, we find that the excess return for sellers is primarily associated with those firms selling assets (buildings such as stores, hotels and factories.) Our hypothesis is that such assets have tax benefits that the market values. ... (27)

A recent study by Ronald C. Rutherford and Hugh O. Nourse concluded that

**... the formation of a corporate real estate unit results in an increase in shareholder wealth for the parent firm's stockholders.** The largest gain is made by firms whose primary line of business is real estate. The organization form associated with the largest shareholder gain is the publicly traded subsidiary, with gains occurring before and after the announcement of the event. The formation of wholly owned subsidiaries, master limited partnerships, and real estate investment trusts also resulted in wealth increase. But, the formation of a centralized real estate department resulted in a decrease in equity value for the firm. These findings suggest that the market makes a distinction in terms of type of corporate real estate unit formed. ...

These findings are consistent with the claim that real estate assets have been underutilized, and that the active management of real estate is the responsibility of the firm if it intends to maximize its shareholder wealth. ... (28)

The sample of firms contains 20 central real estate departments, 14 wholly owned subsidiaries, 8 publicly traded subsidiaries, 10 master limited partnerships, and 19 real estate investment trusts. ... (29)

**Clearly, real estate plays an important role in mergers and acquisitions. Regardless of the corporation's main line(s) of business, corporations generally increase benefits to their shareholders if they form a corporate real estate unit that is independent of the operating company.**

## CHAPTER 2

### PLANNING CONSIDERATIONS

**"An undervalued company under full-scale takeover attack has little chance of remaining in control, and being unprepared can be very expensive.**

----David Webb (30)

In today's business environment focusing on mergers and acquisitions, good business strategy for a publicly traded corporation includes policies for the prevention of an unwanted takeover. **How does the CFO know if his/her assets are undervalued and, therefore, his company is at risk of being acquired? Also, what planning considerations should the CFO focus on when examining specific strategies? And finally, what planning strategies exist to prevent an unwanted takeover from occurring?**

### VALUATION

While factors such as a low price to earnings ratio, high cash flow, unused borrowing power, or a highly liquid financial condition provide increased vulnerability to takeover, **companies are most likely potential targets of a hostile suitor if they are undervalued.** These entities can be classified into two different categories: those that are valued conservatively and/or those with high breakup value. (31)

Companies are required to record their assets at historical cost in accordance with generally accepted accounting principles. As a result, most corporation's real estate assets and lines of businesses are not reflected at their true market value. **It follows the true net worth of these assets are probably not reflected in the corporation's stock price.** Examples of these companies may include natural resource companies such as oil and gas and timber companies (32) as their reserves are reflected at the lower of cost or market (net realizable).

Companies with high breakup value include those with separate and distinct asset groups, high capitalization of groupings of assets, and separate and identifiable company parts. Generally, the value of the parts of this type of entity is worth more than the company as a

whole. Companies such as parking lot operations, retail stores, and those maintaining warehousing facilities are included in this group. Examples include **Allright Auto Parks** which was purchased by a Hong Kong investment group in 1982 and **Federated Department Stores**, purchased by **Campeau Corporation** in 1988. (33)

Determining the value of a company can be a complex task, depending on the complexity of the corporation's operations and the magnitude of its asset base. To determine if your company is undervalued, the CFO should begin his/her analysis with appraisals on its assets. These appraisals, in many cases, may be required as part of a corporation's loan agreements. Valuation of lines of businesses will probably require outside expertise. **Ascertaining the difference between the fair market value/breakup value and the historical cost is the starting point for any defense mechanism using an asset base against hostile takeover.**

### ACCOUNTING METHODS

Mergers and acquisitions present opportunities with respect to presentation of financial statements. Accounting Principles Board # 16 provides that "... two methods of accounting for business combinations - 'purchase' and 'pooling of interests' - have been accepted in practice ... (34)

#### The Purchase Method:

The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation. {The purchase price is allocated to tangible and intangible assets and to liabilities. Any unallocated purchase price is recorded as goodwill. Expenses such as depreciation are calculated using the new basis of assets.}

#### The Pooling of Interests Method:

The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The

recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for prior periods is combined and restated as income of the combined operation. ... (35){Expenses such as depreciation are calculated using the old basis of assets.}

**NOTE: It is imperative that any corporation consult with its financial accounting advisors before entering into any legal arrangement that might limit flexibility.**

### **TAX IMPLICATIONS**

While it is impossible to consider more than a few tax strategies in this paper, several statutes of the Internal Revenue Code of 1986 are particularly worth mentioning and should be considered when devising defense takeover strategies.

#### **IRC Section 311: Taxability of Corporation on Distribution (of Appreciated Property)**

Internal Revenue Code Section 311 provides the rule for the taxation of appreciated property distributed to its shareholders. "... No gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of (1) its stock (or rights to acquire its stock), or (2) property. **The exception to the general rule includes the distribution of property where "... the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation).** If such property is distributed, "then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value. (36)

#### **IRC Section 382: Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change**

The Tax Reform Act of 1986 implemented new rules with respect to the ability of carryover of net operating losses from the acquired corporation when a change of ownership occurs involving a 5% owner or equity structure shift.. Section 382 of the Internal Revenue Code provides as a general rule **"the amount of taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year. ...The 382**

limitation for any postchange year is an amount equal to ..the value of the old loss corporation, multiplied by the long-term tax-exempt rate. ..." The long term tax-exempt rate "...shall be the highest of the adjusted Federal long-term rates in effect for any months in the 3-calendar-month period ending with the calendar month in which the change date occurs. ..."

Further, **"...if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero."** An ownership change occurs when immediately after any owner shift or an equity structure shift (most reorganizations) occurs involving a 5-percent shareholder "...the percentage of the stock of the new loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the old loss corporation ... owned by such shareholders at any time during the testing period. ..." (37)

### POISON PILLS

Poison pills have become a fairly common means to forestall a hostile takeover.

In a classic 'flip-in' poison pill, target grants to its shareholders rights to purchase additional common or preferred shares of target at deep discount if a large block of stock of Target is purchased in a transaction that is not approved by its board of directors. ... The initial issuance of the rights should not be a taxable event. Rather, the rights should be treated as part and parcel of the underlying common shares unit; the triggering condition occurs, at which time the rights become separately tradable. (38)

### STOCK ARRANGEMENTS

Stock transactions between corporations have also been used to prevent hostile takeover.

Some targets have issued stock to a white knight to avoid unfriendly takeover attempts. The simplest means is a straight sale of stock at fair market value, usually financed by debt incurred by the white knight. This technique has become less attractive because of Section 246A of the Internal Revenue Code ... which generally denies the right to claim the dividends-received deduction with respect to dividends received on the stock to the extent the holder has incurred debt directly attributable to the investment in stock. Section 246A can be avoided by having two targets issue their stock to each other. Under Section 1032, no gain is recognized on the issuance of stock by each potential target.

Each has a basis in the other's shares equal to the market value of the shares on the date of the cross-issuance. (39)

### GREENMAIL

Greenmail is a payment "made in connection with, or in a transaction related to" the acquisition of the target company's shares by the acquiring entity. Section 5881 of the Internal Revenue Code imposes a 50% excise tax on the gain realized by the acquiring entity upon the receipt of greenmail. (40)

### CURRENT LEGISLATION

According to James Conley, tax partner with **Ernst & Young's** National Tax Group in Washington, D.C., Congress is currently considering legislation that will limit interest deductibility for many mergers and acquisitions. According to Mr. Conley:

The current legislation, which has not been adopted to date, characterizes certain debt instruments as preferred stock resulting in the reclassification of cash payments on the debt as dividends {which are not deductible by the operating company} instead of deductible interest expense {which is deductible under current law}. Specifically, any debt which contains (1) a yield of greater than 5 percentage points over the applicable federal rate and (2) contains deep discount will be reclassified.

The description of the bill does not define "deep discount." However, the joint committee staff indicated the definition will provide that deep discount exists if the accumulated discount (unpaid interest) at the end of any period is greater than the yield to maturity multiplied by the issue price (one year's interest). Should this legislation pass, it will have tremendous impact not only on merger and acquisition financing dependent on junk bond and other forms of discounted instruments, but also on working capital loans. (41)

**NOTE:** Again, it is imperative that the various entities consult their tax advisers to determine specific treatment of various facts and circumstances prior to entering into a specific transaction as this writing is not designed to cover all possibilities.

## **LEVERAGE:**

A recent concern mentioned in connection with the current merger and acquisition trend focuses on the amount of leverage (the amount of borrowed funds or debt) in relation to equity. According to Businessweek,

By the end of 1988, nonfinancial companies will, within six short years, have nearly doubled their debt, to \$1.8 trillion, and retired more than \$400 billion in equity. This year's {1988} corporate interest bill will equal nearly 24% of corporate cash flow - a debt-service burden seen only when recessions squeeze profits. Yet the drive for debt shows no signs of slowing down. ... Critics worry that investment bankers often instigate recapitalizations with more of an eye on their own fees than the the client's future. With dealmakers able to finance an additional \$150 billion in LBOs, a speculative bubble could well be building. ... Last year, 87 companies defaulted on \$21.4 billion. ...

Despite the risks, however, this heightened leverage may be inevitable. The fat balance sheets of the Fifties and Sixties may be a luxury the U.S. can no longer afford. **Borrowing means that companies work their capital harder - which is essential to remain competitive in world markets. ...**

...Under outside pressure, managers borrow to squeeze "hidden value" from assets. Then they must streamline operations, slash bureaucracies and labor costs, shut down inefficient plans, and redirect their energies. Debt is a strict disciplinarian. ...

Even though no one likes to pile on debt, there may be ample room for stepped-up borrowing. One key measure - the ratio of debt to the market value of equity - suggests companies in general are not overleveraged. The ratio peaked at a frightening 106% in the 1974 bear market. As stocks recovered, the ratio improved - to 83% by 1984, and to around 75% now. With stock values outscaling the climb in debt, it's clear that investors expect restructurings to pay off in rich future profits. ....

**Companies in Europe and Japan, what's more have long lived with debt burdens that U.S. businessmen consider hair-raising. Even today, U.S. companies are only about half as leveraged as their major foreign counterparts - which makes foreigners eager to lend here. ...**

For almost five years now, new debt has been displacing new equity as the U.S. economy's risk capital. ... Debt capital is cheap capital, thanks to the {tax} law. Interest payments are tax-deductible, while dividend payouts aren't. ... The driving force behind most increases in leverage, however, is management's desire to stay in charge. ... Even in more conventional situations debt can work wonders to make management look good. ... A



management willing to live with idle debt capacity, including untapped real estate assets, may be depriving its shareholders and tempting the raiders. (42)

### **POSTACQUISITION LAYOFF**

Another concern commonly associated with mergers and acquisitions is the termination of employees due to economies of scale. While it is an important consideration in all mergers and acquisitions, it may be even more so in the disposition of real estate and/or lines of businesses since many jobs are directly related to these activities within the corporate setting. According to John E. Panos in a recent article entitled "postmerger Integration: Taking the Humane Approach to Postacquisition Layoffs",

work force cuts that are aimed at bolstering benefits of an acquisition can boomerang on a ham-handed management. Sagging performance could wipe out anticipated gains when the morale of both departing and retained workers is shattered. **Although the job is never painless, a sensitive downsizing that is properly communicated can keep the combined organization on key.**

If a postacquisition downsizing seems like a sound way of gaining the benefits of business consolidation, results are often hard to come by. In place of immediate benefits, the combined company may face a work force backlash that not only postpones the rewards, but also creates new problems and exacerbates existing ones. Whenever a business action involves layoffs of people, there obviously are no painless ways of handling it. Yet, a downsizing that is well-planned offers opportunities to achieve the goals of acquisition with reasonable dispatch while minimizing business and personal headaches.

The policies that are established to implement the layoff have to be thought of through not only in terms of the people who will be terminated, but also with an eye toward the perception that is left with the people in the continuing organization. How the process is perceived will in part depend on the degree of sensitivity that is used in terminating employees and the overall communication plans that are effected as part of the downsizing. ... (43)

**In summary, the CFO should consider accounting methods, tax implications, leverage, and post acquisition layoffs when formulating defense mechanisms against or facing a hostile takeover.**

### **TAKEOVER DEFENSE STRATEGIES**

A recent article by Alan M. Berman, Robert J. Jinnett, and Robert A.N. Cudd of the New York law firm of LeBoeuf, Lamb, Leiby, and MacRae investigated some planning

considerations for hostile takeovers involving real estate. One school of thought provides that a company finding itself the subject of hostile takeover should plan a **defense strategy** to achieve some success in the transaction. Results from such strategy could range from causing a delay that would improve a defensive position, forcing the bidder to make a better offer, or allowing time to generate a competing bid, to achieving absolute success in a hostile takeover campaign. **Generally, defensive strategies can be classified in three groups: the elimination of the characteristic which makes the target attractive to the raider, making of a competitive offer by management, or threat of corporate dismemberment.** (44)

Prior to implementation of any type of defense mechanism against hostile takeover, the entity should undertake several planning considerations including:

- \* Are the real estate holdings suitable for sale, spin-off, etc.?
- \* Are any filings with the SEC required?
- \* Is shareholder approval required?
- \* Are shareholders entitled to appraisal rights?
- \* Are any other regulatory or exchange approvals required?
- \* Is the consent of mortgagees, lenders, lessors, or lessees required?
- \* Will potential buyers require environmental clearances?
- \* Will transfer taxes be incurred?
- \* Will sale at the current time yield optimum value or a distressed sale? (45)
- \* How will these decisions affect current management, employees, and shareholders?

### **ELIMINATION OF CHARACTERISTICS MAKING THE TARGET ATTRACTIVE**

Prior to finding itself in a hostile takeover situation, the corporation should consider whether it needs to retain control of its real estate holdings. If it does not, it is possible that a complete or partial liquidation of its holdings could help prevent a hostile takeover. (46) Further, it may provide the entity with additional operating capital to enhance its profitability.

#### **Liquidation**

Depending on the nature of the corporation's business(es), the liquidation of real estate by outright sale which is not needed for current or future operations may be feasible.

Properties the corporation wants to retain control of can be sold and leasedback as described below.

The tax ramifications of a sale include the recognition of gain or loss upon the disposition of the asset. To determine this amount, the entity would take its adjusted basis (historical cost - tax depreciation) against the net sales price (sales price less selling expenses). If the corporation has net operating loss carryovers from previous years, it is possible the entity may recognize the sale without incurring an actual tax liability.

### Sale-Leaseback

As mentioned, in situations where the corporate entity wishes to maintain control over the real estate assets, a sale-leaseback may be considered. (47) The sale leaseback involves the actual sale of property while simultaneously executing a lease or management agreement for the property for a predetermined period of time. "In a sense, a target company that liquidates its readily salable real estate holdings may be maintaining control of itself by voluntarily accomplishing part of the same liquidation contemplated by the offeror." (48)

The corporation would recognize gain or loss for tax purposes as described above. Thereafter, the entity would deduct its lease payments as ordinary and necessary business expenses.

Companies included in recent transactions include: **Crocker National Bank** which sold and leased back its Los Angeles headquarters and **Carson Pirie Scott & Co.**, a Chicago real estate chain that sold two of its resorts in 1981 making a \$21.4 million profit over the book value while retaining partial control over the properties by staying on as manager of the resorts. (49)

### Spin-offs

"Another strategy for raising the target company's stock price by eliminating undervalued real estate assets is to spin off the real estate into a subsidiary entity that can be separately valued. ..." Essentially, the target could spin off its real estate assets into a separately traded entity such as a master limited partnership (MLP). The MLP is traded on a securities exchange. "This technique also allows the target company's shareholders to realize

the benefits of the earnings stream generated by the transferred assets free from the corporate taxation of the earnings."

A transfer of property to the limited partnership will not trigger the recognition of taxable income to the corporation unless the liabilities assumed by the partnership create a deemed distribution of cash or the target company sells a portion of its assets to the partnership for cash or other property. Distribution of MLP units to shareholders will cause the target company to recognize gain on the distribution, with the shareholders recognizing income equivalent to the fair market value of the units as dividend income. Note: With the exception of certain publicly traded partnerships that the Internal Revenue Service (IRS) treats as corporations, MLPs will not be subject to the corporate-level income tax as long as the MLP derives 90% of its income from interest, dividends, real property rents, gains from the sale or disposition of real property and income and gains from various activities involving natural resources.

Recent examples include the **Transco Energy Company** which put its oil and gas properties into an MLP in 1983 entitled Transco Exploration Partners and sold 12% of its units to the public. In 1985, **Unocal** spun off certain Gulf Coast assets into a publicly traded MLP to thwart a **T. Boone Pickens, Jr.** takeover. ..." (50)

#### Use of a Liquidating Entity:

An alternate suggestion would be the spinning off of a corporation's assets into a liquidating entity, such as a liquidating trust or partnership. A corporation may use this strategy when it has a number of properties that will require a longer time to sell without risk of distress sale. "... By spinning off the real estate into another entity, the target company also may be able to cause an increase in its stock price because of the marketplace's re-evaluation of its real estate. ..."

A liquidating trust generally is most suited to real estate holdings that could be treated as a passive investment not requiring any management activity such as timber or raw land. A liquidating partnership is most suited to a company where the real estate portfolio requires active operation and management such as hotels and resorts. Examples of liquidating trusts are the **Houston Oil Royalty Trust** formed by **Houston Oil and Minerals Corporation** in 1980 and **Mesa Royalty Trust** formed by **Mesa Petroleum Co.** in 1979. Both "were formed to achieve a true marketplace appraisal of the oil companies' undervalued assets."

Examples of liquidating partnerships include the spinning off of certain Hawaiian commercial real estate holdings by **Dillingham Corporation**.

The Tax Reform Act of 1986 repealed the provision codifying the General Utilities doctrine. Consequently, "... a corporation will be taxable on the distribution of appreciated property as if such property were sold at fair market value." A distribution of an interest in a partnership or a trust is "... taxable to the distributing corporation and will constitute a dividend to the shareholder to the extent of accumulated earnings and profits of the corporation. ..."

Although it is possible to avoid the corporate-level taxation on the distribution of the spin-off of stock in a controlled corporation if the five-year trade or business test has been met, that test generally cannot be satisfied in the case of investment real estate. The IRS takes the position that a real estate investment trust (REIT) is prohibited from engaging in an active trade or business; therefore, a REIT cannot be used as a vehicle to distribute real estate to shareholders in a tax-free reorganization. Accordingly, it is not generally possible for a corporation to incorporate its real estate portfolio and spin off stock of the controlled subsidiary in a tax-free transaction.

In a case where the real estate is used in an active trade or business, however, such as the hotel business, and has been conducted for five years or more, it would be possible to effect a tax-free spin-off. **TWA** recently used this approach by spinning off its airline and retaining its hotel, food, and real estate subsidiaries, all of which met the five-year trade or business test. (51)

#### MAKING A COMPETITIVE OFFER:

Assuming that a corporation failed in preventing pursuance by a hostile raider, a second major strategy aimed at blocking the offer is for the target company itself to generate an internal offer that will be more attractive to the shareholders than its opponent's offer. In order to be successful at this strategy, it is likely that target will have to communicate "... the management's opposition to the takeover bid, supported by appraisals showing the bid is less than the actual market value or replacement cost of the company's assets."

Assuming this strategy is not available, the target company could seek out a white knight to make a competitive offer. Using this strategy does not alleviate the white knight from turning into a grey knight, whereby management and assets are liquidated. In some cases, the corporate management may attempt to act as its own white knight and attempt an LBO of the company.

A third possibility provides the target company 's utilization of a leveraged recapitalization "... whereby the target company takes on debt to buy back its outstanding shares, with the shareholders receiving cash plus "stubs" representing interests in the restructured company." (52) Issuance of additional stock rights is also a possibility.

### **THREATENING CORPORATE DISMEMBERMENT**

The most drastic option available to the pursued is the threat of dismemberment or complete liquidation rather than to succumb to a hostile takeover. "For example, a 'crown jewel' lockup option could be effected to a white knight allowing it to purchase the target's prime real estate holdings if the offeror proceeded with the takeover attempt. ..." The "... target might also spin off its real estate into a subsidiary, with the stock of the subsidiary automatically being distributed as dividends to the shareholders. ..."

In addition, the target may implement additional poison pills involving the sale of real estate including financing techniques. Most recently, however, crown jewels options and poison pills have been attacked successfully.

"As a result, they likely will be upheld only where the courts determine, among other things, that the target company's board of directors (1) has fulfilled its fiduciary duty to obtain the highest price possible for the target company's stock or assets and (2) has fairly and reasonably exercised its business judgement to protect the corporation and its shareholders against injury likely to befall the corporation, should the tender offer proves successful."(53)

### CHAPTER 3

## THE PERSPECTIVES OF THE ACQUIROR, THE LENDERS, AND THE TARGET

When implementing a strategy using corporate real estate assets as a defense mechanism, understanding the roles of the various players is beneficial. This chapter gives the perspective from a few of the market's more dominant forces in hopes that their experiences will provide additional insight to the complex field of mergers and acquisitions culminating in a presentation of facts on takeover attempts involving MacMillan, Inc., Perini Corporation, and U.S. Home Corporation.

### THE ROLE OF THE ACQUIRING CORPORATION

ShearsonLehman Hutton recently published *Strategies for Completing a Successful Acquisition*. These strategies are generally applicable to mergers and acquisitions and can be tailored to those corporate raiders who are looking to utilize undermanged corporate real estate.

#### Step 1: Develop Acquisition Criteria

"Acquisition criteria should be a by-product of thorough and thoughtful examination of the company's strengths and vulnerabilities. Once developed, senior management consensus on acquisition criteria is critical."

#### Step 2: Develop "Watch List"

"...Develop a list of acquisition targets that fit the criteria. The names that have been selected should then be ordered in terms of desirability based on their strategic value and price." (54) In the case of real estate, a corporate raider would search for entities that hold prime properties that have not been recently acquired or purchased as well as those that have long term leases in prime areas of the country.

#### Step 3: Decide on Acquisition Strategy

"At this point in the process, a company must decide whether to take a proactive or reactive approach."

#### Step 4: Deal Tactics

Pricing is a key issue. Strategies relating to "pre-empting an auction process", unilateral bids, legalities, etc. should be considered to "..divert the target's attention from its defense."

#### Step 5: Financing

"Usually before an auction is won-or prior to, or during, the launch of a unilateral bid-financing must be lined up to assure the seller that the transaction can be completed on a timely basis." (55) As discussed below, real estate is an integral part of many financing strategies.

#### Step 6: To Win

"A winning strategy involved locking up a deal before the marketplace inflates pricing to unattractive levels."(56)

Mr. John Hodge, who is with a Texas entity that has been a major player in the merger and acquisition/LBO field during the last several years, commented on the acquiror's role. The entity's holdings include the recent acquisition of a Fortune 500 corporation through a leveraged buyout. According to Mr. Hodge, **the key to any acquisition is the financing which is contingent on "the cash flow generating capacity of the entity and the potential cash flow from asset sales (divisibility)."**

According to Hodges, the **real estate holdings are a "supplementary but very important" issue** of importance behind cash flow and divisibility. With respect to a company's real estate holdings, he noted the difficulty of determining the worth of a corporation's holdings if the takeover attempt is not friendly, stating that it requires "detective work" since specific details of assets are not disclosed in public documents. He also noted the importance of "older corporation's leaseholds which are often very, very valuable" and "hidden options for rights to purchase properties."

John noted that while real estate is an important part of many transactions, **financing strategies may limit the acquiring corporation's flexibility once the corporation has been acquired.** With respect to strategies, he noted that for highly leveraged companies, "bank loan agreements and bond debentures may limit your ability to sell specific



real estate assets. Always keep in mind the tax aspects of the sale of any real estate assets." Finally, he noted that a high debt placed on the newly acquired entity's assets may lower the entity's credit rating. "If you sell and lease the assets back, the decline in your rating may increase your rental payments since many owners value real estate like a bond." (57)

Also, in a recent article by Kidder Peabody & Co., real estate was noted as "an extremely important source of cash. A great many companies are putting that cash to use in financing acquisitions or in recapitalizing to enhance shareholder value." (58)

## THE ROLE OF INVESTMENT BANKING

"The handful of investment banks that dominate the merger business are increasingly viewed as repositories of knowledge where a business can be sold, and for how much. Indeed, investment banks are being looked to for specific judgements about the value of a company as a whole..." (59)

-----J. Tomilson Hill,  
(Managing Director of Shearson Lehman  
Hutton's Mergers and Acquisitions  
Department)

There is little doubt that investment bankers play a significant role in mergers and acquisitions. In response to a question concerning "what ... is driving the high level of mergers, and particularly, hostile bids ..., Mr. Hill, in an interview which appeared in "Directorship: Significant Issues Facing Directors" in 1989 stated:

... To understand why M&A activity is increasing, you have to look at broad trends within both the domestic U.S. economy and the international economy. The trends fall into two categories: **industry consolidation and financial considerations**. First, in terms of consolidation, almost industry by industry, merger activity over the last five years can be explained by a company's desire to consolidate operations and achieve economies of scale through acquisitions. ... Through consolidation, costs are reduced, businesses become more efficient, market shares increase. All this makes companies become more competitive on a worldwide basis.

The second reason for today's level of merger activity has to do with two key financial considerations. The first is **financial restructuring**. Over the last five years, many companies have decided to get back to basics, to re-examine their diversification efforts in terms of core businesses and to basically make their acquisitions along the core line. The second financial consideration is the **enormous liquidity** that exists in the marketplace. Roughly \$30 billion of equity funds are available in the leveraged buyout firms. Using a normal

leverage ratio of 10 to 1, this translates into buying power of approximately \$300 billion. You also have the commercial banks wanting to earn fees and to put money to work in the LBO business.

Some critics argues that investing in leveraged buyouts has all the earmarks of the Third World loan problems. We disagree fundamentally with that analysis. The banks are lending on a secured basis primarily to U.S. companies where earning power is predictable, and they're lending on the basis of cash flows. And if there's a problem, lenders are in a position to restructure the business and, in effect, "work out", the leverage. In fact most of the LBOs have been recapitalized either by being sold or taken public, or have dramatically restructured their debt through asset sales. ... (60)

With respect to the role that investment bankers have played in mergers and acquisitions, Mr. Hill stated:

Historically, investment banks have played only one role, and that was as a **financial advisor**. Increasingly, investment banks have been playing broader roles, particularly in helping to finance transactions. The concept of investment banks becoming merchant banks that provide **bridge financing** to help facilitate transactions, has become a common phenomenon in the merger business. **Investment banks are now more often called on to provide subordinated bridge financing, ultimately to be refinanced in the high-yield market for the purpose of expediting transactions.**

In addition, the handful of investment banks that dominate the merger business are increasingly viewed as repositories of knowledge of where a business can be sold, and for how much. Indeed, investment banks are being looked to for specific judgements about the value of a company as a whole - or in various parts, in cases where an acquisition is divestiture driven. In the last several years we have been asked a number of times to provide opinions on divestitures for companies that we've worked with on the buy side.

**We're really being called on increasingly to lend our knowledge and experience as to the value of businesses and who the buyers are for particular properties, as well as to provide sophisticated pricing judgments in complicated transactions. (61)**

According to M.A. Hines,

**... until recently, real estate has not been an integral part of investment banking.** Its rise may be attributed to three basic causes: (1) a decline in the stock and bond business after the October 19, 1987 stock market crash; (2) increased real estate activity, with more sophisticated instruments and financing methods; and (3) increased merger and acquisition activity involving major real estate holdings. ... Real estate investment banking involves a large portion of the real estate and financial communities.

The traditional investment banking 'players' are generally involved in the real estate markets, also. These include security issuers, real estate borrowers and lenders, mortgage guarantors, and insurers from the public and private sectors, as well as investment bankers. Also involved are residential and commercial real estate brokers and estate agents, property managers, portfolio asset managers, real estate appraisers, land use regulators, title insurance company personnel, and other real estate people. And of course, there are the credit rating services, which have developed practical rating systems for residential and commercial property finance in the United States that may be applied to overseas residential and commercial property finance. To aid the development of global real estate investment banking, credit rating services are entering the international financial arena with overseas branch offices that focus on overseas entities. ...

The normal areas covered by real estate investment banking are:

- \* Real estate and mortgage advice and counsel;
- \* Brokerage services, including real estate, mortgage and security brokerage;
- \* Security underwriting;
- \* Asset management (portfolio and property);
- \* Property finance; and
- \* Property development. ... (62)

**"In most major corporate or real estate transactions, an investment banking house advises each of the parties to the negotiation ... {particularly in} ... company mergers and acquisitions where there is substantial real estate involved ..."**

Numerous recent mergers and acquisitions of companies with heavy real estate interests have generated work for investment bankers. Even potential mergers and acquisitions have created fee payment work for Wall Street. The potential acquisition of Santa Fe/Southern Pacific by The Henley Company or by Olympia & York is one example. Both California-based Henley and Toronto-based Olympia & York are seeking the valuable major real estate resources of the diversified transportation company. The commercial real estate developments and undeveloped land, part of which is in railroad rights-of-way, may be worth more than the total operating value of the company. Both suitors plan to sell off most of the acquisition, retaining primarily the valuable real estate. The investment bankers have been paid fees for their advice about the prospective financing of both of the proposed company takeovers. Once a takeover occurs, the Wall Street firms can look forward to the commissions from the sales of the various operating companies. ...

When a company acquires a target, it usually seeks financing advice from one or more investment bankers in order to "digest" (financially) the targeted company. The issuance by investment bankers of high volumes of junk bonds has often resulted from the follow-up financing takeovers, both hostile and friendly. The bankers get the underwriting and marketing fees for the new

securities immediately, and - possibly - trading commissions and fees later, as the securities enter the secondary market.

Usually, each suitor is represented by one or more investment banking house in its negotiations with the target company. Of course, the winning team's investment bankers are likely to receive much higher compensation than the investment bankers working for the losing companies. (63)

## THE ROLE OF THE COMMERCIAL BANK

A senior vice president at one of Boston's most respected lending institutions commented on the role of the commercial banks: "We provided the senior debt, and they provide the equity." He indicated that some large financial institutions will also provide a portion of the equity, but generally "commercial banks are oriented toward the debt side of the transaction." (64)

## THE TARGET CORPORATION

The role of the target corporation can range from "prepared" to experiencing "complete surprise" at a hostile takeover attempt. For those targets that are prepared, they have a greater chance of exercising some control over the situation. Generally, these corporations have discussed the possibility of a hostile takeover attempt with management and its board of directors and designed strategies to cope with the situation when it arises.

Of particular concern is a perception cited by Ms. Jane Harris in a 1989 study of Valuation of real estate assets conducted at the Center for Real Estate Development at Massachusetts Institute of Technology. "Generally managers concluded that any potential value to a raider from real estate assets would be insignificant relative to total firm value and costs of takeover." (65) While this perception in isolated instances may be accurate, it was also found by this author when interviewing two Fortune 500 companies (names withheld) that had millions of dollars in real estate throughout the world. **The viewpoint of current management in these cases, is clearly contradictory to that of the acquiring corporation which looks to real estate as an important part of financing an acquisition.**

With respect to the concern that management loses control once a company is put into play for takeover, Mr. Hill of Shearson stated:

**A lot depends upon the relationship that the chairman and the CEO has with his board as to whether the management has substantial flexibility in facing an unsolicited offer.** If the chief executive has worked with his board to prepare the directors for the possibilities of an unsolicited offer; if the board has been familiarized with the kinds of decisions that they will have to face under attack; if the board has a relationship with and confidence in the advisors, the financial and legal advisors, then I think the chemistry between the board and the management, specifically the CEO, and the advisors is one where there is room for creative solutions, depending upon the circumstances.

In many ways, each takeover is unique and distinct. It is hard to generalize about how a board or a management will react without knowing the specifics of a particular bid and bidder. If, for instance, a board is facing a low offer from a financial buyer in which the financing is questionable, then the board has very substantial latitude to explore options, some of them creative and unusual. If, on the other hand, the board is facing an offer from a major corporation, fully financed at what is characterized as a pre-emptive price, then the options facing the board become reduced substantially. ...

A lot depends upon the nature of the bid that is being faced and also the desire of the CEO to play the critical role. Based on our experience, CEOs will maintain control of the process. However, in varying degrees they will rely upon advisors to provide key advice at critical points. In many instances, managements will take the investment bankers' advice; in other instances, management may, in fact, determine that they have a different game plan and will not agree with an investment bank's or a lawyer's assessment of the outcome. Again, a lot depends upon the nature of the CEO and his relationship with his board. A lot also depends upon the quality of the advice that is given by the law firm as well as the investment bank.

... Some of the most creative offenses, have been orchestrated by a strong CEO who determines that, taking all the advice into account, he has a game plan that will work. So I think to say that a CEO loses control to his advisors in the face of a bid is not a true statement at all. (66)

To effectively, illustrate the perspective of the target in varied circumstances, three case studies are presented as appendices. Two of the case studies, Perini Corporation and U.S. Home Corporation were successful in driving away an unwanted suitor. The third, Macmillan, Inc., was not. A brief summary of each case study is listed below.

### PERINI CORPORATION (See APPENDIX 1)

During 1984, Perini Corporation spun-off certain real estate properties, partnership interests, and \$6 million in cash to a new entity, Perini Investment Properties. Briefly, the Board of Directors of Perini Corporation cited three reasons for the spin-off:

- 1.) provide two separate securities which would more accurately reflect the value of the different businesses;
- 2) encourage expansion of income property ownership and management activities with a particular emphasis on maximization of cash flow and appraised values;
- 3) allow PIP to raise additional equity capital for expansion.

During the 1982-1983 operating period, a hostile takeover of Perini was attempted. Senior management indicated that the takeover attempt "accelerated an ongoing process {restructuring} which was already under consideration."

The restructuring was effective. The hostile takeover attempt was abandoned. A comprehensive analysis of Perini's objectives and the actual results are included in the Appendix.

### MacMillan Inc. (APPENDIX 2)

During 1988, the Robert M. Bass Group, Inc. began a takeover bid for MacMillan, Inc which triggered a defense through a restructuring plan. The Bass Group filed a preliminary injunction, challenging the restructuring. The court ruled against MacMillan. Subsequently, Robert Maxwell won control of the company by offering a higher price than the Bass Group. The point of interest in this case study is the standards adopted by the court when reviewing restructuring plans invoked to ward off acquirors.

### U.S. Home Corporation (APPENDIX 3)

During May through July of 1986, Pacific Realty increased its ownership in U.S. Home Corporation to 9.2%. On June 26, 1986, the Board of Directors of U.S. Home Corporation declared a dividend distribution to its shareholders of common stock which included specific provisions applicable to any "merger of other business combination." On July 17, 1986, U.S. Home Corporation announced the receipt of a proposal from Pacific

Realty which stated its desire to combine U.S. Home Corporation with a subsidiary of Pacific Realty Corporation. The Board of Directors of U.S. Home rejected the proposal. Pacific Realty eventually abandoned its takeover attempt.

## CHAPTER 4

### CONCLUSIONS

Considering the research and the case studies presented, the author submits the following conclusions:

#### **MERGERS AND ACQUISITIONS WILL LIKELY CONTINUE IN A GLOBAL MANNER**

Given the recent trends in the U.S. and the spread of mergers and acquisitions to Europe, it is likely these trends will continue as companies strive to increase or protect their market share. Many companies must now look abroad to remain competitive either through sales, production, or both.

#### **REAL ESTATE IS AN IMPORTANT ASSET AND IS A FOCAL POINT OF MANY MERGERS AND ACQUISITIONS**

Since real estate is not presented in the financial statements at fair market value, the company may be undervalued, an invitation to hostile takeover. The 1981 Massachusetts Institute of Technology study of real estate management concluded corporate management is largely ineffective in managing real estate, a factor which has not changed since 1981. It is, therefore, understandable why so many companies have been acquired for their underlying assets only to find themselves broken up and sold off.

Many corporate managers make the argument that "we are not in the real estate business" as a rationalization not to manage real estate. While in the case of most corporation's businesses the statement itself true, an asset that comprises 25% or higher of the corporation's total assets projects the entity into the field of real estate, like it or not.

Also, corporations must realize that financing a merger and acquisition relies in part on the ability of the acquiror to sell assets which often focuses on real estate. Many acquiring corporations actually plan disposition of real estate in the first few operating months of the newly acquired entity to reduce levels of debt and/or increase cash flow.



## **MANAGEMENT IS CHARGED WITH THE RESPONSIBILITY OF MAXIMIZING WEALTH WHICH REQUIRES EFFECTIVE UTILIZATION OF REAL ESTATE**

Management must decide whether its shareholders are the best owners of a business. If another corporate entity can produce more long term value from the assets than present management, the assets or the company should be sold. Management is charged with maximization of shareholder wealth and should not be self-serving.

Management must begin to utilize its real estate assets in a more strategic fashion. If not, another corporation will acquire the entity, replace existing management, and affect the necessary changes. **It is highly unlikely that a corporation effectively managing its assets and maximizing shareholder wealth will sustain a hostile takeover attempt.**

## **THE UTILIZATION OF REAL ESTATE AS A DEFENSE MECHANISM SHOULD ALSO RESULT IN INCREASED VALUE TO THE SHAREHOLDER**

The most important premise of this paper is that management should not affect takeover defense mechanisms to preclude all offers. Management should institute defense mechanisms against hostile takeovers that are not in the best interests of the present shareholders. Any defense mechanism involving real estate should focus on the protection of the shareholder's investment and a simultaneous increase in the value of the company, and therefore, the shareholder's wealth.

As mentioned in Chapter 1, "the formation of a corporate real estate unit results in an increase in shareholder wealth for the parent firm's stockholders." **Therefore, publicly traded corporations should consider the following specific recommendations for the utilization of real estate as a defense mechanism against hostile takeover:**

### **RECOMMENDATION 1:**

Consider the spin-off of real estate holdings to a publicly traded subsidiary or related corporation. As exemplified by Perini Corporation's spin-off of real estate into Perini

Investment Properties (See Appendix), the stock of the two separate companies will generally trade higher than the original entity's stock since the market will give value to the corporate real estate. Perini Corporation maintained ties to the new entity through interrelationships of construction and management and, therefore, enhanced its business operations.

RECOMMENDATION 2:

Consider spin-off of assets to a wholly owned subsidiary, master limited partnership , or real estate investment trust. Proper legal arrangements will ensure the ability of the corporate entity the right to use these properties on a long term basis.

RECOMMENDATION 3:

Consider the actual sale of real estate if your company doesn't need it. If retention is necessary, by entering a sale/leaseback arrangement, your company can recognize immediate profits in the year of sale while retaining the right to use the property for years to come. The disposition of undervalued real estate will reduce the chance of hostile takeover.

RECOMMENDATION 4:

Consider the issuance of debt covenants that require immediate payment of mortgages upon change of ownership in excess of a specified percentage. By tying in the loans to a change in ownership, your company will provide the hostile acquiror incentive to negotiate with present management if it wants to consummate the acquisition.

RECOMMENDATION 5: Consider the issuance of additional stock upon a change of ownership in connection with recommendations 1-4 or other similar poison pills. Again, the hostile acquiror will need to negotiate to affect the transaction.

## APPENDIX 1

### PERINI CORPORATION: SPIN-OFF OF ASSETS

Perini Corporation, headquartered in Framingham, Massachusetts, is a recognized industry leader in construction and real estate development. Founded before the turn of the century, the company has been for many years listed among the Fortune 100 leading diversified service companies in the United States.

Perini provides both private clients and public agencies with general contracting, construction management and design-build services throughout the United States, with Perini International Corporation constructing projects primarily in Africa, South America and the Middle East. Majestic Contractors Limited, a leading pipeline construction and consulting engineering firm headquartered in Edmonton, Alberta, performs oil and gas pipeline construction throughout Canada; and through Majestic, the company owns a 45% interest in Monenco Limited, a multi-discipline international consulting and engineering firm.

Perini Land & Development Company, a wholly-owned subsidiary, conducts extensive real estate operations in Arizona, California, Florida, Georgia and Massachusetts.

Shares of Perini Corporation, both common (PCR) and depository convertible exchangeable preferred (PCR-PF), are listed and traded on the American Stock Exchange. (67)

### THE FACTS

On March 16, 1984, the Board of Directors of Perini Corporation (Perini) approved in principle an Agreement and Plan of Reorganization and Corporate Separation, pursuant to which Perini transferred its wholly-owned income producing real estate properties, certain real estate partnership interests and \$6 million in cash to a newly established New York corporation known as Perini Investment Properties, Inc. (the company). All of the outstanding common stock of the company was distributed on May 2, 1984 (the Distribution Date) on a share-for share basis to the stockholders of record of Perini as of March 26, 1984 (the Distribution). (68)

The "Notice of Distribution to Stockholders" of Perini Corporation dated March 28, 1984 stated:

Notice is hereby given that Perini Corporation, a Massachusetts corporation ..., has declared a distribution, pursuant to which Perini will distribute to its stockholders 100% of the outstanding shares of the Common Stock, par value \$1.00 per share, of Perini Investment Properties, Inc., a New York corporation ... wholly-owned by Perini. ... (69) On the Distribution Date, Perini will

distribute to holders of Perini Common Stock on the Record Date, without any consideration being paid by such holders, shares of PIP Common Stock on the basis of one share of PIP Common Stock for each share of Perini Common Stock held. ... Based on the number of shares of Common Stock of Perini outstanding on March 16, 1984, 3,252,239 shares of PIP will be distributed. (70)

### **REASONS FOR SPIN-OFF**

The Board of Directors of Perini has determined that it is in the best interests of its stockholders to separate its income producing real property ownership and management business from its construction and real property development operations and to distribute the property ownership business to existing Perini stockholders. ... The Board of Directors has determined that the Distribution will accomplish three principal business objectives:

1. To provide Perini stockholders with two separate securities which will more accurately reflect the value and prospects of its different businesses.
2. To encourage an expansion of its income property ownership and management business by isolating this business in a separate company which will focus on maximizing cash flow and appraised asset values.
3. To allow PIP to raise additional equity capital for expansion of its business at a cost that is estimated to be less than would be the case were Perini to raise the equity capital for such an expansion itself. (71)

The objectives were again reiterated in the 1984 Perini Investment Properties (PIP) Annual Report's Letter to Stockholders signed by David B. Perini, Chairman of the Board, and Thomas A. Steele, President and Chief Executive Officer,

the prime reasons for creating this company were, first to gain market recognition of the value of the company's assets by isolating and highlighting the cash flow and asset appreciation benefits of cash-flow-oriented real estate properties. Second, by gaining recognition of these benefits we felt we could raise additional capital on a favorable basis - a key element in creating a growing portfolio of properties. Our ultimate goal: to provide steady, continuous growth of long-term shareholder value. (72)

In a personal interview, Mr. Steele stated the value of cash flow from income producing properties was not properly reflected in Perini Corporation's stock since stocks are generally valued on earnings recognition and not cash flow. Since most income producing properties, showed a book (and generally a tax) loss, the effect was to dilute the earnings of Perini Corporation without valuing the actual cash flow generated by these properties.

In addition, the major real estate joint ventures recorded on the consolidated balance sheet prior to spin off reflected a negative basis, thereby reducing Perini Corporation's net worth. (As previously mentioned, non-consolidated joint venture and partnership interests are accounted for on the equity method in accordance with generally accepted accounting principles. The reflection of a negative basis on a corporate balance sheet is a contra-account that has the same effect as a liability for the computation of net worth.) Therefore, the spin-off of these interests actually increased the GAAP net worth of Perini.

A significant concern of Perini's real estate group was that it could not buy or produce income properties and hold them because of their "negative impact on earnings." Because of their book losses, "the only way to develop was to have a contract for sale. There was no means for holding the properties without an eventual adverse impact on earnings." In summary, Mr. Steele noted that "the holding of these and similar properties within Perini had a negative effect on earnings, profit generations, and book return on investment because the public reporting gave no consideration to the generation of cash flow." (73)

### **THREAT OF HOSTILE TAKEOVER**

During the 1982 - 1983 period of operations, Charter Oak attempted a hostile takeover of Perini, acquiring between 10 - 15% of Perini's outstanding common stock. According to Tom Steele, the attempt "came while we were looking at the restructuring." While the takeover attempt was not a cause of the restructuring, it "accelerated an ongoing process which was already under consideration." Perini subsequently purchased Charter Oak's stock. (74)

### **FEDERAL INCOME TAX CONSEQUENCES OF THE DISTRIBUTION**

Perini has received a ruling from the Internal Revenue Service that no gain or loss will be recognized by (and no amount will be included in the income of) the holders of Perini Common Stock upon the receipt of PIP Common Stock. The basis of the Common Stock of PIP and the Common Stock of Perini, together, will be the same as the basis of the Perini Common Stock held immediately prior to the Distribution, allocated in proportion to the fair market value of each immediately following the Distribution. ... (75)

## **CORPORATE STRATEGY: PIP**

### **Valuation**

Mr. Steele said several options were considered to resolve the dilemma which would allow the marketplace to value Perini's stock at its true worth. One alternative was to place "all real estate in a public corporation with the construction company in another public entity. We rejected this alternative from the construction company's viewpoint since a majority of the company's asset base also would have been transferred. In effect, the construction company would have become a service company with a much smaller asset base and more volatile earnings. The two pieces separately would most likely have been worth less than the existing corporation."

The second alternative, which was ultimately chosen, entailed the transfer of certain cash-flow oriented real estate assets to a separate corporate entity. **NOTE:** As described above, this alternative actually increased the net worth of the remaining entity. Steele noted that the resolution was the "convergence of economic undervaluation in the marketplace in Perini and a maturing organization, Perini Land & Development, that wanted to expand its presence in its marketplace. By expanding its presence into income oriented properties, we could also create more opportunities for PL&D." As mentioned, Perini Investment Properties was formed in 1984 to accomplish these tasks. (76)

"Perini Investment Properties, Inc. owns , manages, and develops a variety of income properties for the purpose of generating cash flow and long-term asset appreciation. Depending on the project, company participation may take the form of a sole ownership or partnership structure." (77)

### **Relationship with Perini Land & Development Co.**

The 1984 Annual Report cites the valued relationship between PIP and Perini Land & Development Co. (PL&D).

At the outset, PIP's intention was to utilize the development experience of PL&D in the identification and eventual acquisition of portfolio properties. And, in fact, all of PIP's initial projects have come to our attention as a result of PL&D's regional development efforts in California, Arizona, and Massachusetts. In addition, the projects themselves are representative of

another management objective: to provide both geographic and product diversity in the expansion of PIP's portfolio. We are confident that the expertise of PL&D (the area managers of which are also officers of PIP) will continue to provide valuable income property purchase and development opportunities, helping to ensure continued growth of Perini Investment Properties. (78)

### **PORTFOLIO STRUCTURE: PIP**

PIP seeks cash-flow-oriented properties in the California, Arizona, Massachusetts, Florida and Georgia markets. Our objective is to balance the distribution of gross asset value in these areas to assure appropriate geographic diversification.

Through product diversity, we seek to mitigate risk associated with a concentration in any single product type and to provide greater overall return to shareholders for the level of risk incurred. The current portfolio consists of the following types of property investments: office/industrial; commercial office; urban mixed-use; residential; hotel; and shipping center. (79)

### **CASH FLOW AND CURRENT VALUE**

At PIP, cash flow levels form the basis of value and equity measurement. Company growth comes about through increasing levels of cash flow and market value from the current portfolio and new project acquisition/development. Increases in cash flow from these sources create leveraging opportunities which have a significant effect on underlying portfolio value. ...A continuing goal at PIP is to increase net cash flow per common share and net current value per share at a compound annual rate of 15% over the long term. (80)

To emphasize its focus on cash flow, it was necessary for PIP to obtain the SEC's permission to report its results based on cash flow per share as well as earnings per share. Although several others have obtained permission since then, PIP was the innovator in this field. According to Steele, this reporting method "attempts to have the marketplace focus on cash flow and not earnings." To emphasize current value of its assets, the fair market values of PIP's holdings are published as part of the annual report. (81)

### **TAX OBJECTIVES & NET INCOME**

"A by-product of the elimination of taxable earnings is the creation of book losses for accounting purposes. **In this company, cash flow (not net income) is the relevant**

**measure of company progress and determines funds available for dividends and portfolio reinvestment." (82)**

With respect to performance measurement, "... the company also emphasizes appraised asset value and net current value per share. As a result of the distortion created by depreciation deductions, rather than appreciation recognition, a real estate firm's balance sheet prepared on the required 'generally accepted accounting principles' (GAAP) basis understates both asset values and economic net worth." (83)

### **DIVIDENDS**

"PIP will tie its dividend payout to a minimum of 50% - 60% of net cash flow from operations. A stated PIP goal regarding dividends was reached at mid-year 1987 when both common and convertible preferred dividends reached a nontaxable, return of capital status. All 1988 dividends are classified as return of capital." (84)

### **RESULTS OF OPERATIONS**

#### **Net Cash Flow From Operations Per Share (85)**

1988	1.24
1987	1.14
1986	1.00
1985	0.80
1984	0.69

#### **Net Current Value Per Share (86)**

1988	26.41
1987	23.58
1986	21.57
1985	19.26
1984	17.46



### NET INCOME (LOSS) PER SHARE (87)

1988	(0.74)
1987	(1.58)
1986	(0.44)
1985	(0.08)
1984	0.57

(Since 1984, net current value has increased 51%; cash flow per share, 80%).

### ANALYSIS

As stated above Perini's objectives in the spin-off were directed at the accomplishment of "three principal business objectives". This analysis will attempt to determine whether the company was successful in meeting its goals.

"To provide Perini stockholders with two separate securities which will more accurately reflect the value and prospects of its different businesses."

This objective can be divided into two distinct parts. First, was Perini successful in providing two separate securities to its stockholders? As previously mentioned, Perini was successful in the spin-off of certain real estate assets to its shareholders by the distribution of PIP's common stock in 1984. Therefore, the first portion of the objective was met.

Second, do these securities "more accurately reflect the value ... of its different businesses?" To ascertain this, it is important to look at the value of the stock of Perini before and after the spin-off of PIP. Since the primary purpose of the spin-off was the accurate reflection of value of the real estate assets by the marketplace through the value of common stock, one can hypothesize that the value of Perini and PIP in aggregate should exceed the trading value of Perini alone prior to spin-off.

To test this hypothesis, the average trading values of Perini's and PIP's common stocks for calendar years 1980-1988 must be determined. Second, the values of the combined

stocks must be compared with Perini's average trading value for the three years prior to announcement of spinoff.

**PERINI CORPORATION\***  
**AVERAGE TRADING VALUES**

	<u>1988</u>	<u>1987</u>	<u>1986</u>	<u>1985</u>	<u>1984*</u>	<u>1983***</u>	<u>1982</u>	<u>1981</u>	<u>1980</u>
HIGH	32.13	33.03	32.19	29.41	28.94	41.19	29.88	29.22	20.53
LOW	27.59	26.66	26.78	25.59	24.38	32.88	20.22	20.41	14.81
AVG	29.86	29.84	29.48	27.5	26.66	37.03	25.05	24.81	17.67

**PERINI INVESTMENT PROPERTIES\***  
**AVERAGE TRADING VALUES**

	<u>1988</u>	<u>1987</u>	<u>1986</u>	<u>1985</u>	<u>1984**</u>
HIGH	18.15	18.84	15.41	13.28	13.75
LOW	15.41	14.31	12.5	11.56	11.25
AVG	16.78	16.61	13.95	12.42	12.5

\* High and Low values were determined by calculating the average high and low common stock trading prices for all four quarters of each year. (88) (89)

\*\* Includes second and third quarters only as spin off occurred in second quarter.

\*\*\* The spin-off of PIP was announced in 1983.

**COMBINED AVERAGE TRADING VALUES OF PERINI AND PIP**

<u>1988</u>	<u>1987</u>	<u>1986</u>	<u>1985</u>	<u>1984</u>
46.64	46.45	43.4	39.92	39.16

**AVERAGE TRADING VALUE OF PERINI PRIOR TO SPIN-OFF  
ANNOUNCEMENT**

1982	25.05
1981	24.81
1980	17.67
<b>AVG</b>	<b>22.51</b>

**RESULTS**

As calculated above, the average trading value of Perini Corporation's common stock for the period of 1980-1982 was \$22.51 per share. Perini's annual report indicates that 1980 was a very successful year. 1981 was noted as having "record earnings". From a management's perspective, 1982 was the "best year ever." Therefore, it seems reasonable to use these values for comparison as a test comparison. When comparing the average value of the stock, using a growth rate of 10% per year in the value of the company, and, therefore, the stock, the following conclusion can be made:

	<b>AVG VALUE</b>	<b>COMBINED VALUE</b>	<b>DIFFERENCE</b>
1983	22.52	N/A	N/A
1984	24.77	39.16	(14.39)
1985	27.25	39.92	(12.67)
1986	29.97	43.40	(13.43)
1987	32.97	46.45	(13.48)
1988	36.20	46.64	(10.44)

For each year, 1984 - 1988, the combined value exceeded the average value of the common stock adjusted by the 10% growth factor. Therefore, Perini met its objective of more accurately reflecting the value of its businesses. The one concern, however, is the fact that PIP's stock is trading below the current value. As mentioned above, net current value for 1984 - 1988 was 17.46, 19.26, 21.57, 23.58, and 26.41 per share with the average trading price was 12.50, 12.42, 13.95, 16.61, and 16.78 per share. While Perini has been successful in tapping additional value for its assets, the marketplace still places a significant discount on the value of the shares. (30-40%)

According to Tom Steele, "we expected it {the value of the stock when compared to net current value per share} to be higher. Perini's goal was that PIP's trading value would be between par and a 10% discount from net current value. "We have not been able to achieve this maximum value which may be attributed to market skepticism over current value reporting and generally disfavorable attitudes that the market has towards real estate. We are currently seeking ways to correct this and maximized shareholder benefits." (90)

"To encourage an expansion of its income property ownership and management business by isolating this business in a separate company which will focus on maximizing cash flow and appraised asset values."

From its initial operating date in 1984, PIP expanded its holdings via acquisition and exchange to enter or strengthen its market presence in its targeted areas of the United States. The fair market value of assets held in 1984 and 1988 was \$120,453,000 (91) and \$288,671,000 (92), respectively or approximately an 140% increase. In structuring its assets acquisitions and exchanges, PIP clearly is focusing on maximizing cash flow and appraised values. Therefore, this objective has been met.

"To allow PIP to raise additional equity capital for expansion of tis business at a cost that is estimated to be less than would be the case were Perini to raise the equity capital for such an expansion itself."

As exemplified in its 1985 annual report, Perini has been successful in meeting this objective. During 1985, the Company generated \$15,059,000 through the sale of 1,650,000 shares of \$1.10 convertible preferred stock. The Company also has a \$15,000,000 revolving credit agreement. The Company employed these resources in purchasing various assets and partnership interests during the year. ..." (93)

## CONCLUSION

For all intents and purposes, Perini Corporation, through its spin-off of real estate assets to Perini Investment Properties, was successful in obtaining market recognition of the companies' values and, successfully reduced its chances of being pursued by a hostile acquiror while simultaneously increasing shareholder wealth.

## APPENDIX 2

### RESTRUCTURING: MACMILLAN INC.

According to Shearson Lehman Hutton's Merger and Acquisition Report, Winter of 1988, the MacMillan Inc. restructuring provides insight in light of a takeover.

On May 17, 1988, Shearson Lehman Hutton's client, the Robert M. Bass Group, Inc. began its takeover bid for MacMillan, Inc. The \$64 per share offer triggered an immediate defense by MacMillan in the form of a restructuring plan. The fight for control of MacMillan provides a good lesson in how this defense can backfire.

In his overtures to MacMillan, Bass stressed that his offer was a friendly one and was conditioned on board approval. The Texas financier said he intended to retain MacMillan's managers and invited them to participate in negotiations. Despite Bass' willingness to negotiate, a special committee of independent directors at MacMillan saw Bass as a threat to the company and stepped up efforts to complete their restructuring plan.

On May 30th, the MacMillan board voted to adopt the restructuring plan and reject the Bass offer. The details of the restructuring incorporated several key provisions:

- \* A split-up of MacMillan into its publishing business and information business;
- \* MacMillan's shareholders would receive \$52.35 in cash, a \$4.50 debenture, a stub share of the publishing business valued at \$5.10 and a one-half share of the information business valued at \$2.20;
- \* 39% and effective control of the information business would be retained by management;
- \* Several hundred thousand restricted MacMillan shares and stock options would be granted to management;
- \* The MacMillan Employee Stock Ownership Plan would purchase 26% of the stock of the publishing business with \$120 million of company-provided stock; and
- \* Golden parachute severance provisions for top executives would be adopted.

On June 4th, the Bass Group made a second, higher offer of \$73 per share in cash that MacMillan rejected on June 8th. The Bass Group also proposed an alternative restructuring proposal where it would pay cash for the information business stock that would otherwise go to management and MacMillan shareholders would receive \$5.65 more than they would receive under management's proposal. This proposal was rejected as well.

Challenging the restructuring plan, the Bass Group filed for a preliminary injunction in the Delaware Chancery Court in Wilmington. On July 14th, **the court ruled against MacMillan and enjoined the restructuring.**

**The standards followed by the court in evaluating the propriety of the restructuring plan are useful guidelines for determining when a restructuring plan is the best defense.** The following six points number among those a board of directors should consider in determining the nature of an unsolicited bid and how they might respond to it:

1. Evaluate the threat ...
2. Investigate the bidder ...
3. Consider available anti-takeover devices ...
4. Make sure your response is reasonable ...
5. Do stockholders have a choice? ...
6. Does the restructuring offer the best deal? ...

**The MacMillan decision provides some guidelines which must be considered when formulating a restructuring in response to a perceived takeover threat:**

\* Where the proposed restructuring involves management participation and a conflict of interest could or does exist between management's proprietary interests and its concern for stockholder welfare, a special committee of independent directors should be formed (aided by independent financial and legal advisors) to evaluate the restructuring proposal and negotiate with management on behalf of the company.

\* If control is passing from the public shareholders to management, the determination as to the fairness of the restructuring should take into account where a control premium is being paid to shareholders. For companies with a large number of shareholders, effective control can exist with less than 50% of the shares. In MacMillan, management's proposed 39% equity interest was found to constitute effective control of the information business.

\* If the proposed recapitalization is in response to a third party bid which poses a minimal threat to corporate policy and effectiveness, then the value of the recapitalization to the company's stockholders should approximate or exceed the value of the competing offer.

\* If the third party bid poses a substantial threat to the company, it may not be necessary for the value of the restructuring to approximate or exceed the competing bid, particularly if the shareholders have a choice in the matter.

All circumstances presented will determine the fairness and reasonableness of the proposed restructuring.

## **EPILOGUE**

The court's injunction of Macmillan's restructuring plan opened the way for other parties to bid for Macmillan. After the court's injunction, the Bass Group commenced an all-cash tender offer for all the outstanding shares of Macmillan for \$75 per share. Subsequently, Robert Maxwell and KKR each put in a bid for the company at a price substantially higher than the Bass tender offer, and Maxwell ultimately won control of the company.(94)

### APPENDIX 3

#### STOCK RIGHTS PLAN: U.S. HOME CORPORATION

On May 28, 1986, a spokesman for Dallas-based Pacific Realty Corporation, parent company of Pacific Realty/New York Corporation issued a statement regarding its recent investment activities in U.S. Home(7.43%) including the following remarks:

1. U.S. Home has a large G/A expense ratio to its sales compared to the rest of the industry.
2. It has continuing involvement in some depressed markets which have created a drain on corporate resources and management time.
3. It has other non-single family home building businesses which have not been performing well that have added to the drag in both its overhead and earnings. ...

We have been meeting with the new management team at U.S. Homes since we announced our major position in the company and believe that they are cognizant of the problem as mentioned and have now embarked on a direct path toward devising permanent solutions to these problems in as short a time as possible. ... We are optimistic that these major restructuring decisions will set U.S. Home on the road to recovery and we feel that the new management is going to be effective in taking the necessary steps toward accomplishing these goals in short order. (95)

On July 10, 1986 Pacific Realty issued the following statement:

Pacific Realty Corporation announced today that it had increased its ownership in U.S. Home Corporation from 6.7% to 9.2% Pacific has retained the investment banking firm of Prudential-Bache Securities, Inc. as its financial advisor in connection with this investment.

Pacific further announced it will be considering various other options regarding this investment among which is an offer for the acquisition of U.S. Home Corporation; however, no decision has been made to date regarding this particular option.

Pacific Realty Corporation is a nationwide developer of multi-family, commercial and retail properties in 50 cities in 20 states. (96)

The following excerpt was taken from the U.S. Homes "Summary of Rights to Purchase Preferred Stock":

On June 26, 1986, the Board of Directors of U.S. Home Corporation ... declared a dividend distribution of one right for each outstanding share of common stock, par value \$.10 per share ... Initially, the rights will be attached



to all Common Stock certificates representing shares then outstanding, and no separate right certificates will be distributed. ...

In the event that the Company is acquired in a merger or other business combination transaction where the Company is not the surviving corporation or where the Common Stock is exchanged or changed or 50% or more of its assets or earning power are sold, ... proper provision shall be made so that each holder of a right shall thereafter have the right to receive, upon the exercise thereof at the then current exercise price of the right, that number of shares of common stock of the acquiring company ... which at the time of such transaction would have a market value of two times the exercise price of the right. ... (97)

In a news release on June 27, 1986, U.S. Homes noted:

The Board of Directors of U.S. Home Corporation adopted a Stock Rights Plan intended to discourage unsolicited and coercive under-priced offers to purchase the Company at a time when its stock may be under valued and not reflective of the long term value of its business. The Plan is designed to protect stockholders against unsolicited attempts to acquire control of the Company, whether through aggressive accumulation of shares in the open market or partial or two-tier tender or exchange offers, that do not offer a fair price to all stockholders. The Plan will encourage potential acquirors to negotiate with Directors of the Company in order to ensure that long-term stockholder values will be maximized. The Plan should also address some of the disruptions created by market accumulators who seek to acquire stock in a manner which is not in the best interest of all stockholders. By discouraging these abusive tactics, the Plan promotes the fair and equal treatment of stockholders. The Plan is not being adopted in response to any specific takeover attempt.

Under the Plan, rights to purchase shares of a new series of Preferred Stock will be distributed as a dividend for each outstanding share of common stock. Each Right will conditionally entitle stockholders to buy one-hundredth (1/100th) of a share of newly-issued Series A Preferred Stock at an exercise price of \$21. Each one-hundredth of a share of the U.S. Home preferred stock will have dividend and voting rights and other attributes approximately equal to those of one share of U.S. Home common stock, but will have a liquidation preference. The Rights will be exercisable only if a person or group acquires 20% or more of U.S. Home common stock or announces a tender or exchange offer which would result in ownership of 20% or more of the common stock. U.S. Home will be entitled to redeem the Rights at 'one-cent' per Right at any time until 20 days after a 20% position has been acquired and thereafter at 'two-cents' per Right in connection with certain mergers or business combinations approved by the Company.

If any person becomes the beneficial owner of 30% or more of U.S. Home common stock or if U.S. Home enters into a business combination with a 20% stockholder and U.S. Home's stock remains outstanding after the transaction or if a 20% stockholder engages in certain self-dealing transaction with U.S. Home, then each Right not owned by such person or related parties will entitle its holders to purchase, at the Right's then-current exercise price, a package of U.S. Home securities consisting of U.S. Home common stock and preferred

stock having a market value at the time of exercise of twice the Right's exercise price. In addition, if after a stockholder acquired 20% of U.S. Home's common stock, U.S. Home is acquired in a merger or other business combination transaction with another person, each right will entitle its holder to purchase, at the right's then current exercise price, shares of common stock of such other person having a market value equal to twice the right's exercise price. (98)

On July 17, 1986, U.S. Home Corporation announced that it received a letter from Pacific Realty Corporation "setting forth a proposal pursuant to which U.S. Home Corporation would combine with a subsidiary of Pacific Realty Corporation." (99)

On July 24, 1986,

the Board of Directors of U.S. Home Corporation ... unanimously rejected a proposal from Pacific Realty Corporation, of Dallas, to negotiate a merger of U.S. Home Corporation with a subsidiary of Pacific Realty.

The Board noted that Pacific Realty's proposal was highly conditioned, contemplated the issuance of speculative securities and that there was no indication that Pacific Realty had the financial resources necessary to consummate the proposal. Pacific Realty gave no evidence of its ability to arrange the necessary financing.

The Directors of U.S. Home Corporation, in rejecting the proposal, also affirmed the Company's intent to maximize shareholder value by remaining an independent company and implementing the Company's recently adopted program aimed at restoring a profitable level of operations and significantly improving cash flow. It was the sense of the Board that management should not be diverted from pursuing these objectives. (100)

In a personal interview with Ms. Kelly Somoza, Director of Investor Relations, she stated that "We {U.S. Home} would look at a merger if it made sense" and stated the commitment of U.S. Home to act in "the best interest of its shareholders." (101)

## POSTSCRIPT

Pacific Realty abandoned its takeover attempt and reduced its holding in U.S. Home Corp. Since that time, U.S. Home has undergone a significant restructuring. (102) For its year ended December 31, 1988, U.S. Home returned to its first profitable year since 1983 reporting net income of \$5,028,000. (103)

## ENDNOTES

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- (10) "Dealmaking: RJR's Stratospheric Pricing", *Mergers and Acquisitions*, p. 10.
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- (12) *Ibid.*
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- (14) Barry Vinocur, "Wanted: Real Estate Rich Companies", *Real Estate Aler: The Arthur Young Real Estate Letter*, p. 2.
- (15) Bergsma, *op. cit.*, p. 23.
- (16) William Meyers, "Corporate Real Estate Comes Out of Hiding: *Institutional Investor*", Volume 22, June 1988, p. 106.
- (17) Robert H. Plattner and Jerry T. Ferguson, "Profit Center for Corporate Real Estate," *Real Estate Review*, pp. 80-81.
- (18) Bergsma, *op. cit.*, pp. 23-24.
- (19) Peter R. Veale, "Managing Corporate Real Estate Assets: A Survey of U.S. Real Estate Executives," *The Laboratory of Architecture and Planning, Massachusetts Institute of Technology*, 1988, p. 1.
- (20) *Ibid.*, p. 4.
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- (22) *Ibid.*
- (23) *Ibid.*, pp. 9-11.
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- (25) "Real Estate Adds Up, Too (Corporate Real Estate as Takeover Target) *Bus. Mon.* Volume 131, May 1988, pp. 80-81.
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- (32) *Ibid.*, p. 8.
- (33) *Ibid.*
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- (35) *Ibid.*, p. 204.

- (36) The Internal Revenue Code of 1986, Section 311.
- (37) The Internal Revenue Code of 1986, Section 382.
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- (40) Ibid., pp. 215-216.
- (41) Telephone Interview: James Conley, Tax Partner, Arthur Young, July 21, 1989.
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